No. 14594

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

[illegible] SMITH and ROSE MAE SMITH,

Appellants,

vs.

[illegible] C. WESTOVER, former Collector of Internal Revenue and ROBERT A. RIDDELL, Director of Internal Revenue,

Appellees.

APPELLANTS' OPENING BRIEF.

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Appellees.

APPELLANTS' OPENING BRIEF.

Jurisdiction.

This is an appeal from a judgment for Appellees rendered by the United States District Court for the Southern District of California, Central Division, the Honorable Leon R. Yankwich presiding, and docketed and entered on August 23, 1954.

Said proceeding involves claims for the refund of federal income taxes and interest for the calendar years 1943 to 1948, inclusive, in the following total amounts:

By Appellant Jack Smith	$56,965.08
By Appellant Rose Mae Smith	54,256.32
By Appellants jointly	8,557.73
Total	$119,779.13

All of said amounts were paid to Appellee Harry C. Westover except $2,955.17 for the calendar year 1948, which was paid to Appellee Robert A. Riddell.

Notice of this appeal was dated November 2, 1954 and was filed November 3, 1954, pursuant to the provisions of 28 U. S. C. A., Section 1291.

Opinion Below.

The only previous opinion rendered in this cause is the Memorandum Decision of Judge Yankwich, filed June 24, 1954 [Tr. 15-20]. Findings of Fact and Conclusions of Law were signed by the trial court August 23, 1954 [Tr. 20-30]. Judgment for Appellees was rendered August 23, 1954 [Tr. 30-31]. The trial court's Memorandum Decision and the Findings of Fact and Conclusions of Law are reported in 123 Fed. Supp. 354 (1954).

Issues Involved.

There are two issues involved:

(1) Did Appellees err in ignoring for the period from October 1, 1943 through December 31, 1944, a partnership evidenced by a written agreement, consisting of Appellants and two trusts, of which Appellants' children were beneficiaries, wherein assets were owned and profits and losses divided on the following basis:

Jack Smith	40%
Rose Mae Smith	30%
Jack Smith, Trustee for Barbara Ann Smith	15%
Rose Mae Smith, Trustee for Howard Samuel Smith	15%

and in taxing the income of the last two named partner trusts equally to Appellants.

Although no community property was involved Appellees did not challenge the partnership so far as the Appellants were concerned.

(2) Did Appellees err in ignoring for the period from January 1, 1945 through June 30, 1948, a partnership evidenced by a written agreement and consisting of Appellants and two trusts, of which Appellants' children were beneficiaries, together with a non-related individual, Herman Weishaupt, wherein assets were owned and profits and losses divided on the following basis:

Jack Smith	36%
Rose Mae Smith	27%
Jack Smith, Trustee for Barbara Ann Smith	13½%
Rose Mae Smith, Trustee for Howard Samuel Smith	13½%
Herman Weishaupt	10%

and in taxing the income of said two named partner trusts equally to Appellants.

Appellees approved the partnership with respect to Appellants and Weishaupt.

Statutes Involved.

The Internal Revenue Code of 1954 is not here applicable. References which follow involve the prior Internal Revenue Code (26 U. S. C. A.).

"Sec. 22. *Gross Income.*

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any

agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such President and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

"Sec. 181. *Partnership Not Taxable.*

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

"Sec. 182. *Tax of Partners.*

"In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * * *

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b)."

Statement of Facts.

This cause was submitted to the trial court by Appellants on the pleadings, a stipulation of facts, oral testimony and written exhibits. Appellees introduced no evidence.

While findings of fact were made by the trial court [Tr. 21-28], it is submitted that said findings are so at variance with the facts as disclosed by the record that a complete restatement thereof is required.

(1) Appellants, husband and wife, are both adult citizens of the United States and residents of the State of California [Tr. 21].

(2) Appellant Jack Smith entered the retail and wholesale shoe business in 1919 and has been engaged in that business alone and in partnership with others in Los Angeles since 1925. Said business was conducted under the name of Boston Shoe Company [Tr. 85].

(3) Appellants were married in 1931. Prior to said marriage Appellant Rose Mae Smith worked for Appellant Jack Smith in his sole proprietorship shoe business. She has been active in said shoe business on a regular day-to-day basis from prior to her marriage until the present [Tr. 63-64].

(4) Appellants have two children, Howard Samuel Smith, born in 1932, and Barbara Ann Smith, born in 1940. At the time of the trial of this proceeding Howard was 22 and Barbara was 14 [Tr. 68].

(5) On December 31, 1942, Appellant Jack Smith purchased from Appellant Rose Mae Smith her community interest in the proprietorship conducted under the name of the Boston Shoe Company [Tr. 65]. The transaction be-

tween the parties was occasioned by disagreement between them as to certain expenditures being made by Appellant Jack Smith [Tr. 87-89] and it was decided to define the interest of each Appellant in the business [Tr. 65]. Said sale was evidenced by a written agreement between the parties, dated December 31, 1942, the effect of which was to eliminate the parties' community interests and create separate estates in both Appellants [Ex. 2;* Tr. 164-169].

(6) At the time of said sale on December 31, 1942, the capital employed in the Boston Shoe Company, according to that concern's records, totalled $254,277.68 [Tr. 92]. Appellants agreed that of said sum $205,867.78 constituted community property and the balance separate property of Appellant Jack Smith acquired prior to marriage. Appellant Jack Smith agreed to pay Appellant Rose Mae Smith for her said community interest one-half of the book value of said community interest, or $102,933.89. Said payments were made by the delivery to Appellant Rose Mae Smith of four interest-bearing notes due one, two, three, and four years respectively after the date of sale, the first three notes being in the amount of $30,000 each and the last note in the amount of $12,-933.89 [Exs. 2, 3, 4, 5 and 6; Tr. 164-171].

(7) Immediately after the sale just referred to Appellant Rose Mae Smith gave considerable thought to creating trusts for the children, Howard and Barbara, and using the notes referred to, or the funds obtainable therefrom through borrowing, for the purchase of investment real estate for said children. No such real estate was acquired, however, because the prices asked were deemed too high [Tr. 65, 66, 70-71].

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*All exhibits referred to are Appellants.

(8) From December 31, 1942, until immediately prior to October 1, 1943, Appellant Jack Smith operated the Boston Shoe Company as a sole proprietorship [Tr. 89].

(9) On or about December 28, 1942, the Appellants gave to each of their children $4,000, depositing said sums in the bank in the names of the children with themselves as trustees. No written trust indenture was entered into at that time [Tr. 68-69, 93].

(10) On September 29, 1943, after substantial consideration, Appellant Rose Mae Smith, as trustor, created an irrevocable trust with her daughter Barbara Ann as beneficiary and Appellant Jack Smith as trustee. The corpus of said trust was one of the $30,000 notes heretofore referred to which was duly transferred to said trust [Exs. 5 and 6, Tr. 171, 195].

Said trust instrument was in writing, was irrevocable, provided for successor trustees, including the Union Bank and Trust Company, provided that income should be accumulated until the beneficiary attained 21 with discretion to distribute income after 21, with one-fourth of principal and income to be distributed at 25, one-fourth at 30, and the balance at 35. In the event of prior death, to issue of the beneficiary, in the absence of issue, to brother Howard.

Said instrument was similar to *inter vivos* trusts in common use and specifically excluded both the trustor and trustee from any benefits thereof [Ex. 7; Tr. 171-193].

(11) On September 29, 1943, Appellant Jack Smith as trustor created a trust identical with that heretofore created by Appellant Rose Mae Smith except that Rose Mae Smith was named as trustee and Howard was named

as beneficiary. The corpus of said trust consisted of three $10,000 United States Bonds which were duly transferred to said trust [Exs. 8 and 10; Tr. 193-195].

(12) Neither Appellant had any relative or close friend with a successful business background whom they cared to name as original trustee of said trusts. Accordingly, each named the other as original trustee [Tr. 101-102].

(13) The cash gifts made to the children on December 28, 1942, and heretofore referred to were transferred to said trusts [Exs. 22 and 23; Tr. 276, 279].

(14) The creation of said trusts and the provisions of said instruments were considered with the officials of the Union Bank and Trust Company and others and copies thereof were lodged with said bank as a successor trustee [Tr. 100-110].

(15) The trusts were created by Appellants for the purpose of creating separate estates for their children. Appellant Jack Smith discussed the trusts with his son Howard on many occasions [Tr. 99, 101].

(16) On September 29, 1943, Appellants entered into a written agreement with each other wherein Appellant Rose Mae Smith purchased from Appellant Jack Smith as her separate property a 30% interest in his sole proprietorship, the Boston Shoe Company. She paid for said interest by delivering to him two of the $30,000 notes acquired upon the sale of her community interest in said business and heretofore referred to [Ex. 11; Tr. 197-202].

(17) On September 30, 1943, Appellant Jack Smith entered into a written agreement with the trustees of the two trusts heretofore mentioned, wherein said trustees

acquired for $30,000 each a 15% interest each in said sole proprietorship. Said trustees paid for said 15% interest by delivering to Appellant Jack Smith the corpus of said trusts consisting in the one case of Government Bonds and in the other of said $30,000 note [Ex. 12; Tr. 202-207].

(18) On October 1, 1943, Appellants and said trustees entered into a written agreement of partnership, each partner conveying to the partnership the interests in Appellants' sole proprietorship acquired as heretofore set forth.

Said partnership was to continue for 20 years [Tr. 217] although the trial court in its Memorandum Decision [Tr. 17] and Findings of Fact XXII [Tr. 27] stated said term was 3 years.

Profits and losses were to be shared as follows:

Jack Smith	40%
Rose Mae Smith	30%
Howard Smith Trust	15%
Barbara Ann Smith Trust	15%

In the event of the death or the termination of the partnership of or by any partner the surviving or non-terminating partners were given the right to purchase the interest of the deceased or terminating partner at book value, contrary to the statement of the trial judge [Tr. 17] and XXIII [Tr. 27] of the Findings of Fact that such right was lodged in Appellant Jack Smith alone [Ex. 13; Tr. 208-234].

(19) Said partners entered into a "Supplement to Articles of Co-Partnership" dated as of October 1, 1943, in which the salaries of Appellant Jack Smith and Appellant Rose Mae Smith were fixed at $25,000 and

$2,400 on an annual basis for the remainder of the year 1943 [Ex. 14; Tr. 234-237].

(20) Appellant Rose Mae Smith, as trustee for Howard, invested a substantial part of that trust's estate (the $4,000 gift heretofore referred to was not so invested) and became a partner in the Boston Shoe Company because she finally concluded that the originally contemplated real estate investments were not advisable [Tr. 72-73]. Said action was not taken to minimize taxes but to create separate estates for the children [Tr. 73-74].

(21) Appellant Jack Smith was willing to enter into the partnership agreement just referred to because Rose Mae Smith wanted to invest her separate property in the business and thought the trusts had more opportunity for earnings in the business than could accrue from any other type of investment [Tr. 93-94, 103].

Appellant Jack Smith was anxious to eliminate the note liabilities created in 1942 by the purchase of his wife's community interest. These outstanding liabilities were impairing his credit and retarding expansion [Tr. 108]. Tax saving to the Appellants, while understood, was not a consideration for the trusts' participation in the partnership. As a matter of fact, as the trial court pointed out, taxes had been high since 1940 [Tr. 107-108].

(22) Since the partnership was not created until more than 9 months after Appellant Jack Smith's purchase of his wife's community interest in the Boston Shoe Company, the parties deemed the capital invested in the partnership on October 1, 1943, by Appellant Rose Mae Smith and the trusts to be "new" capital [Tr. 109].

(23) On January 1, 1945, a new partnership was formed with a new and different written partnership

agreement. The four old partners contributed to the new venture $200,000 of net capital and the new partner, Herman Weishaupt (unrelated to any of the other partners), contributed $22,000.

Earnings and profits were to be shared ratably with the capital invested as follows:

Jack Smith	36%
Rose Mae Smith	27%
Howard Smith Trust	13½%
Barbara Ann Smith Trust	13½%
Herman Weishaupt	10%

Annual salaries, to be deducted as partnership expenses, were fixed as follows:

Appellant Jack Smith	$25,000
Appellant Rose Mae Smith	2,400
Herman Weishaupt	6,000

Said salaries were subject to change upon agreement of a majority in interest of the partners.

Said partnership was to continue for 3 years with successive renewals of 2 years each.

In the case of the death of any partner, options were granted to the remaining partners to purchase the deceased partner's interest at book value.

The partnership agreement could be amended by a majority in interest. All partnership policies were to be determined by a majority in interest among the partners [Ex. 15; Tr. 237-267].

(24) On June 30, 1948, Herman Weishaupt withdrew from said partnership. The four other partners continued the business, reverting to their original percentages [Tr. 111].

(25) Between October 1, 1943 and December 31, 1948, the Howard Smith Trust withdrew from said partnership $81,215.41, leaving its investment in said partnership at $30,181.10 [Ex. 21; Tr. 79-82, 276-277]. Said withdrawals were used for the purpose of paying taxes and making investments in unrelated enterprises [Tr. 79-82].

(26) Between October 10, 1943 and December 31, 1948 the Barbara Ann Smith Trust withdrew from the partnership $75,416.84, leaving its investment in the partnership at $35,979.67. Said withdrawals were used for the payment of taxes and for investments in unrelated enterprises [Ex. 22; Tr. 79-87, 278-279].

(27) The trial court found that there was no siphoning off of income from the trusts for the benefit of Appellants [Tr. 19, 144, 150].

(28) At all times capital was a material factor in the operation of the partnerships [Tr. 86]. See condensed balance sheets, Boston Shoe Company, October 1, 1943 to June 30, 1948 [Ex. 18; Tr. 273].

(29) The salaries paid certain of the partners throughout the existence of both partnerships were based upon the said partners' experience, training, and ability, and constituted reasonable compensation for services rendered. Appellant Jack Smith had been engaged in the shoe business since 1919 [Tr. 85]. Appellant Rose Mae Smith had been connected with the business since 1930 or 1931 [Tr. 63-64]. Herman Weishaupt had substantial experience in the operation of the partnership's business [Tr. 135].

The net income before salaries of the partnerships during the period in question was as follows:

October 1, 1943 to December 31, 1943	(4 partners)	$ 41,579.42
Calendar Year 1944	(4 partners)	124,376.97
Calendar Year 1945	(5 partners)	150,622.03
Calendar Year 1946	(5 partners)	248,575.64
Calendar Year 1947	(5 partners)	86,663.70
January 1, 1948 to June 30, 1948	(5 partners)	68,966.64

Total salaries paid during said periods were as follows:

1943 Period	$ 6,850
Calendar Year 1944	27,400
Calendar Year 1945	33,400
Calendar Year 1946	33,400
Calendar Year 1947	33,400
January 1, 1948 to June 30, 1948	16,700

[Ex. 19; Tr. 274].

(30) All formal and technical requirements incident to the creation of the trusts and the formation and operation of the partnerships were strictly complied with.

(a) The trust agreements were in writing and were complete in all details [Exs. 7 and 8; Tr. 171-194].

(b) The two partnership agreements were in writing and prescribed the rights and duties of the partners in detail [Exs. 13 and 15; Tr. 208-234, 237-267].

(c) The fictitious name certificates provided for by California law were duly prepared and filed for both partnerships [Tr. 163].

(d) Proper and appropriate accounts were set up for each partnership showing the interest of each partner, which accounts were maintained according to standard accounting practices throughout the life of said partnerships [Ex. 18; Tr. 273].

(e) Separate bank accounts and books of accounts were maintained for each trust [Tr. 79-83, 110; Exs. 21 and 22; Tr. 276-279].

(f) All required tax and information returns were duly prepared and filed in behalf of all interested parties.

(g) With respect to each partnership, insurance and other contracts were changed to indicate the partnership ownership [Tr. 110].

(h) Most of the partnership's customers and suppliers were advised as to the identity of the various partners [Tr. 111].

(31) At all times Appellant Jack Smith has expected his son Howard to enter the partnership business [Tr. 94-95]. During the trial of this cause Jack Smith stated that while his son was still in school he, Appellant, still thought that the son would enter the business [Tr. 95]. During the summertime said son worked in the business. [Tr. 74].

(32) From 1943 through 1946 each Appellant herein reported as separate income his share of the partnership income, together with one-half of the salary of each Appellant which was treated as community income. Dur-

ing the same period each trust prepared and filed its own return, reporting and paying tax on its distributive share of the partnership income according to the partnership agreements [Tr. 53-54].

(33) For 1947 and 1948, having been advised of the Treasury's intention to charge the partnership income of the trusts to Appellants, Appellants, to avoid the accrual of interest, included in their individual returns one-half of the combined partnership income of the trusts and paid the tax thereon under protest [Tr. 54]. Claims for the refund of said tax so believed to be overpaid were duly prepared and filed with Appellee [Tr. 9, 13].

(34) Appellees herein have recognized the partnership in question for all years so far as Appellants are concerned even though each Appellant's interest therein constituted his or her separate property. Appellees, however, charged one-half of the combined partnership income of said trusts to each Appellant. Appellees also recognized Herman Weishaupt as a partner in the second partnership.

(35) The trial court found against Appellants, handing down a Memorandum Decision [Tr. 15-20] and signing Findings of Fact and Conclusions of Law [Tr. 20-30]. Judgment for Appellees was then entered [Tr. 30-31].

(36) Objections to the Findings of Fact and Conclusions of Law were duly filed with the trial court but were overruled. Said objections were not embodied in the transcript of record because repeated in Appellants' Motions to Amend Findings and Judgment and for a New Trial [Tr. 32-44].

(37) Appellants' Motions to Amend Findings and Judgment and for a New Trial were denied [Tr. 44]. Thereupon this appeal followed.

Appellants' Statement of Points and Specification of Errors.

1. The District Court erred in entering judgment for the Appellees.

2. The District Court erred in adopting the findings of fact and conclusions of law filed by the Appellees.

3. The District Court erred in adopting the judgment, docketed and entered on August 23, 1954.

4. The District Court erred in denying Appellants motions to amend findings and judgment and for a new trial.

5. The District Court erred in failing to find as a fact that the partnerships involved herein were at all times bona fide partnerships entitled to full recognition for Federal income tax purposes.

6. The District Court erred in failing to enter judgment for the Appellants [Tr. 281-282].

Summary of Argument.

Appellants contend:

That the judgment entered by the trial court for Appellees was clearly erroneous because:

A. The facts as found by the trial court and as set forth in its Memorandum Decision and Findings of Fact are at complete variance with and have no support in the record and, therefore, cannot justify the judgment predicated thereon.

B. The trial court's conclusions of law, and, in particular, the determination that a trust is of no validity unless "court supervised," as that term was understood by the trial court, are in any event clearly erroneous when applied to the facts in this particular proceeding.

C. As a matter of fact and law, both partnerships constituted bona fide business arrangements wherein the parties really and truly intended to carry on business together as partners.

D. In the alternative, that even if it were to be held that the first partnership, existing from October 1, 1943 to December 31, 1944, was objectionable because of the control thereof permitted to be exercised by Appellant Jack Smith, an entirely different situation prevailed with respect to the second partnership of which Herman Weishaupt was a member and which existed from January 1, 1945 to January 30, 1948.

E. Regardless of every other consideration the judgment of the trial court must be reversed because said court made no findings of fact of lack of good faith in the formation of either partnership.

ARGUMENT.

The Judgment Entered by the Trial Court for Appellees Was Clearly Erroneous.

A. The Facts Found by the Trial Court in Its Memorandum Decision and Set Forth in Its Findings of Fact Find No Support in the Record.

These basic errors in fact determination, enumerated below, are not necessarily set forth in logical sequence but, instead, in general follow the Memorandum Decision and Findings of Fact. Some references which may appear trivial are important as illustrating what Appellants respectfully believe to be the trial court's erroneous approach to our entire problem:

(1) Son's Possible Participation in Business:

With respect to this point the trial court in its Memorandum Decision said, after stating that the son had graduated from Stanford University and was about to enter the Harvard Law School [Tr. 16]:

> "These seemingly minor facts are, in cases of this character, of great importance, because, despite the fact that the son may, during his vacations, have worked in the shoe business, he is not preparing for the business and it is not likely that a man with such educational background would engage in such business with his father after completing his education."

Identical language is contained in Findings XIV and XXIX [Tr. 24, 25, 28].

With respect to this point the record [Tr. 95] discloses the following:

> "The Witness (Jack Smith): He (son) is accepted into Harvard Law School now.

The Court: All right. And you think he is going to go into the shoe business?

The Witness: I think he will. Like all lawyers, I think he will eventually end up—

The Court: Then I think you are sending him to the wrong school. A man with a Harvard law degree is not going into the shoe business. He will be too proud of his Harvard degree to go into the shoe business. He may be different."

(2) In referring to the trusts the court said [Tr. 16] and in Finding XVI [Tr. 25]:

"The Trusts are irrevocable. They are subject to the absolute power of the parents as trustees, the beneficiaries having only 'the right to enforce' performance."

As a matter of fact and law, as will be hereinafter pointed out, Appellants as trustees are subject to the usual obligations of fiduciaries and the children as beneficiaries are entitled to faithful performance of the trustees. The trustees are required to accumulate the trusts' income except for payment of trust expenses. The trustees have no discretion respecting distributions to beneficiaries until after said beneficiaries reach the age of 21. Final distributions of corpus and accumulated income are specifically provided for [Exs. 7 and 8, Art. III (c), (d) of each instrument].

(3) The trial court failed completely to differentiate between the two partnerships. For example, in its Memorandum Decision [Tr. 17] and Finding XXII [Tr. 27] the court stated that the life of the partnership was three years. The first partnership was to continue for twenty years [Ex. 13, Art. IX; Tr. 217]. The second

partnership was to continue for three years [Ex. 15, Art. X; Tr. 250].

(4) The trial court stated in its Memorandum Decision [Tr. 17] and in its Finding XVIII [Tr. 27, 28], that at all times throughout the years involved control continued to be exercised by Jack Smith. There is no evidence in the record either based upon practice or upon the provisions of the written instruments upon which said finding may be based.

This finding again illustrates the court's failure to differentiate between the two partnerships. While Appellant Jack Smith had certain broad powers under the first partnership agreement, these powers were completely eliminated in the second agreement.

In the second agreement all matters of partnership policy were to be determined by a majority in interest. *Jack Smith had no absolute powers of any kind.* Further, with respect to the second partnership, Appellant Jack Smith at no time owned a controlling interest even if his individual interest and his interest as trustee were added together. Further, there is no basis for assuming that Appellant Rose Mae Smith would always vote with Jack Smith in matters of disagreement. The record shows conclusively that the parties had from time to time disagreed with respect to certain business policies [Tr. 65, 87-88].

(5) The trial court found [Finding XX; Tr. 26] that the main partners retained the power to determine the salary to be paid to themselves.

This finding is directly contradicted by the express terms of both partnership agreements. The first partner-

ship agreement [Ex. 13, Art. V-2; Tr. 213] specifically provides that the amount of the salaries shall be determined by the partners. Further, the salaries paid under the first partnership agreement were fixed in writing by a separate agreement executed by all of the partners [Ex. 14; Tr. 234-237].

The second partnership agreement also specifically provided that the salaries should be fixed by the partners. Specified in the body of said agreement was the initial amount of said salaries [Ex. 15, Art. VI; Tr. 246]. With respect to a possible subsequent change in the amount of said salaries said agreement specifically provided that a majority in interest in said partnership "at all times has control in all matters requiring the determination of the partners" [Ex. 15, Art. XIV; Tr. 264-265].

(6) The trial court found [Finding XXI; Tr. 27] that, "no business transaction could be conducted by the partnership without the approval of the husband. Nor could it enter into any contract or incur any liability during the life of the husband while he was a partner without his consent."

While arguably such a finding might be justified with respect to the first partnership [Ex. 13, Art. VII; Tr. 215] it was completely erroneous with respect to the second partnership, which covered the period from January 1, 1945 to June 30, 1948. As heretofore pointed out the second partnership agreement specifically provided that in all matters affecting the partnership business a majority in interest should govern [Ex. 15, Art. XIV; Tr. 264-265]. Nor is there any evidence in the record to indicate that Appellant Jack Smith did in fact control in the manner specified the operations of said partnerships.

(7) The trial court found [Finding XXIII; Tr. 27] that the Appellant Jack Smith "was given the right to purchase the partnership at book value, in which event no goodwill could be considered as part of the same."

The necessary inference from said finding is that the right specified was confined to said Jack Smith. Said finding so amplified is directly contradicted by the record.

With respect to both partnerships, *all* the partners had the same right and such right arose only as to the interest of a withdrawing or deceased partner [Ex. 13; Tr. 208-234; Ex. 15; Tr. 237-267].

(8) The trial court found [Finding XXIV; Tr. 27] that "No amendment of the partnership could be made without the consent of the husband Jack Smith."

While such a finding could perhaps be justified with respect to the first partnership agreement, such was not the case with regard to said second agreement.

Said second partnership agreement specifically lodged said right of amendment in the partners entitled to receive a majority of the profits, that is to say, a majority in interest [Ex. 15, Art. XIII; Tr. 263-264]. At no time was said Jack Smith entitled to receive a majority of profits, either in his individual capacity or as trustee, or both combined.

(9) The trial court found [Finding XXVI; Tr. 27-28] "that at all times control was exercised and maintained by the plaintiffs in this action. The creation of the partnership and trust effected no change in the control of the business. The children had no independent voice in the management of the business, either personally or through the trusts."

Said finding, insofar as it purports to constitute a finding of fact, is without justification in the record

either based upon actual practice or the terms of the applicable written instruments.

Prior to the formation of the first partnership, Jack Smith owned and controlled 100% of the business [Ex. 2]. During the first partnership, from October 1, 1943 to December 31, 1944, he owned but 40% individually and 15% as trustee, while Rose Mae Smith owned 30% individually and 15% as trustee [Ex. 13]. During the second partnership, from January 1, 1945 to June 30, 1948, the interests were further changed to 36% for Jack Smith individually and 13½% as trustee, 27% for Rose Mae Smith individually, and 13½% as trustee, and 10% for Herman Weishaupt, in no way related to any of the Smiths [Ex. 15]. Furthermore, there is a basic difference between control exercised with unlimited discretion solely for one's personal benefit and control exercised in a fiduciary capacity as a partner.

(10) The trial court found [Finding XXVII; Tr. 28] "The power to terminate the partnership interest remained upon the terms of the managing partner, namely, Jack Smith."

There is nowhere in the record with respect to either partnership any evidence to support such a finding or from which such a finding might be inferred. A termination by Smith would constitute him a "withdrawing" partner and give the other partners the right to purchase his interest at book value [Exs. 13 and 15].

(11) The court found [Finding XXVIII; Tr. 28] "There was no judicial control of the children's interest through a court controlled trustee or through a guardianship of the estate of the minors." While no *inter vivos* trust is under court supervision in the sense that periodic

reports are required, all trustees are subject to court control.

(12) The trial court found [Finding XXX; Tr. 28] "The said plaintiff Jack Smith voted a very large salary to himself, namely, $25,000." The words "very large" carry with them the inference that said salary was excessive.

As heretofore stated, the salary was determined by the partners in accordance with the partnership agreements and not by the "vote" of Jack Smith. As the facts as stated indicate, the salary to be paid to Jack Smith for his services was reasonable in view of the partnerships' earnings. The trial court, as a matter of fact, erred in not finding that said salary was reasonable.

Further, the finding completely ignores the fact that both Appellant Rose Mae Smith and partner Herman Weishaupt, who as a completely unrelated individual became a partner on January 1, 1945, both received salaries commensurate with the value of their services.

(13) The trial court [Finding XXXI; Tr. 28] found "The plaintiffs retained unlimited control of both the trust and the 'partnership' indicating clearly that the 'partnership' has no existence as a taxable entity."

Again, the trial court ignores the fact that there were two partnerships. Further, there is nothing in the record to justify either as a matter of fact or law the assertion that said plaintiffs (appellants) had unlimited control.

(14) The trial court found [Finding XXXII; Tr. 28] "The children through the trust or otherwise added neither fresh capital nor skill nor even the future expectation of services."

While it is true that the children as such added no skill, since they individually did not participate in the operation of the business, such is not the case either with regard to fresh capital or future expectation of service.

As heretofore explained, on December 31, 1942, Appellants Jack Smith and Rose Mae Smith converted their community property into the separate property of each. Mrs. Smith gave up her entire interest in the Boston Shoe Company, receiving therefor interest-bearing promissory notes. Thereafter, and for a period of nine months, she had no interest in or connection with said business.

The corpus of the Barbara Ann Smith Trust was contributed by Mrs. Smith in the form of one of the notes received by Mrs. Smith as set forth above. When this note was contributed to the capital of the new partnership by said trust it was beyond any question "fresh" capital. When Mrs. Smith contributed as her share of the new partnership capital, $60,000 in said notes, it likewise was fresh capital.

With respect to the Howard Samuel Smith Trust, it is true that the corpus thereof consisted of $30,000 in United States Bonds contributed by Appellant Jack Smith. It may be argued that these assets, since they constituted a credit basis to Mr. Smith, did not constitute fresh capital. To so urge, however, would make it clear that the notes did constitute fresh capital since prior to their contribution they constituted bona fide obligations of Smith's sole proprietorship.

It must not be overlooked in any event that there was not here gifts of undivided interests in an already going business concern, which is the case with respect to many family partnerships which have been the subject of attack.

We have heretofore pointed out that the finding that there was "no future expectation of services" is totally without support in the record. As a matter of fact, the record indicates exactly the contrary.

Under the circumstances we respectfully submit the following:

(a) That the trial court's findings conclusively indicate that the court totally ignored the factual difference between the two partnerships.

(b) That the court's findings of fact being contrary to the evidence cannot sustain the conclusions of law (even if such conclusions were valid) upon which the court predicated its judgment for defendants.

(c) That because of the basic variances between the trial court's findings and the facts as indicated by the record the Appellate Court is free to make its own findings.

(d) That the true facts, regardless of the correctness or incorrectness of the trial court's conclusions of law, indicate that there here existed bona fide partnerships.

B. The Trial Court Misconstrued the Law Applicable to This Proceeding.

The conclusions of law [Tr. 29-30], entered by the trial court and upon which judgment for Appellees was predicated, are so sparse as to be of little assistance.

To ascertain the basis upon which it would appear that the trial court decided this cause it is necessary to refer to the Memorandum Decision [Tr. 15-20] issued by the court and to various comments made by the court during the trial of the proceeding.

In said Memorandum Decision the court referred to six elements which it was asserted were "spelled out in the *Culbertson* and subsequent cases" as indicating that the partnership had no existence as a taxable entity.

Each of these elements will be separately referred to. Some, as has been heretofore pointed out, are primarily statements of fact which, as has been shown, find no support in the record.

(1) "Absence of change of control in the business."

We submit that it has heretofore been made amply clear that this statement has no basis as a matter of fact or law.

Regardless of the "degree" of control exercisable by Appellant Jack Smith with respect to the first partnership such control was completely lacking in the second partnership.

(2) "The power to terminate the partnership interest upon the terms of the managing partner."

We have heretofore amply demonstrated that this statement is completely without foundation so far as both partnerships were concerned. Therefore, any legal significance which this fact, if true, might possess, vanishes.

(3) "The absence of judicial control through a court controlled trustee or through a guardianship of the estate of the minors."

Here would appear to be the heart of the trial court's approach to this proceeding. *In effect the trial court held that because the trustees were not court appointed with the requirement for an annual accounting or were not court appointed guardians that the trusts must be ignored for all purposes.*

This we submit is completely erroneous as a matter of law.

As evidence of the court's basic thinking in this important particular a few references to the record are in order.

(a) Before the trial was three minutes old and before the court had even read the documents in question, the following occurred [Tr. p. 50]:

> "The Court: Was there any action making them (Appellants) guardians of the estate, under the state law?
>
> Mr. Diehl: No guardianship; just a trusteeship.
>
> The Court: In other words, *these were just one of those paper trusts that could be dissolved whenever they wanted to,* and not bound by or controlled by any court. (Emphasis supplied.)
>
> Mr. Diehl: The trusts were irrevocable.
>
> The Court: I know that, but they were not subject to any control by any court."

(b) Transcript page 122:

> "The Court (to Appellant Jack Smith): I see, you are not responsible to anybody because you did not create a guardianship for the children, under which you would have to account every year to the court and the court would pass—
>
> The Witness: But we can't—
>
> The Court: Just a moment (Continuing)—and the court could pass on your acts, and determine whether you used the money wisely or not. So why were you worried about somebody taking money out of the trusts for one purpose or another?"

(c) Again, Transcript page 123:

"The Court: No court could make you put it (trust assets) back because you are not responsible to anybody.

Witness: Your Honor, I went to the best counsel I knew. * * *

The Court: Your son couldn't bring you into court under that trust, and make you account for anything, because your answer would be, 'Everything that is there I gave him, and we made the trusts, and we are not accountable to anybody.'

The Witness: Well, we didn't feel that way, your Honor.

The Court: I am talking legally.

The Witness: We didn't feel that way. Well, I didn't know the legal point."

(d) Again, Transcript page 128:

"The Court: But it is true that your (Appellant Jack Smith) creditors could not touch this trust. I assume they couldn't. I don't know. The creditors could not touch the trust *but you yourself could.*" (Emphasis supplied.)

(e) Again, Transcript page 138 (Testimony of Appellant Jack Smith):

"Q. Did you understand from Mr. Gittelson (Appellant's attorney) that you and Mrs. Smith, as trustees were responsible and accountable to the children for your conduct in the handling of the assets of those trusts? A. That's right.

Mr. Hochman: Your Honor, I object, that is quite a leading question.

The Court: That is all right. So long as I allowed the other one, I will have to allow this one,

to be consistent. *I don't think they are responsible. I don't think any court could touch the trusts.*" (Emphasis supplied.)

(f) Again, Transcript page 139:

"Mr. Lund (counsel for Appellants): Your Honor, if we may, we would like to have the opportunity, even if it is only a short period of time, to file a brief.

The Court: No, * * *

Mr. Lund: We are, frankly, not prepared with authorities on it, because we did not anticipate it.

The Court: It does not make any difference because I *think there is nothing to limit him in drawing it all out and spending it.*" (Emphasis supplied.)

The above quotations show clearly that the court's determination that the trusts had no substance and in effect were shams was the basis for his judgment for defendants. It would likewise appear to be the basis for the court's statement that there was no change in control.

We do not propose to burden this Court with any detailed discussion of the law applicable to the trusts here under consideration. Certain basic points, however, must be noted.

(i) Since the Trusts in Question Were Created Under the Laws of the State of California Their Validity Is to Be Determined Under California Law.

There are certain universal rules which justify the imposition of federal taxes without regard to state law. The trial court, however, went far beyond any such rule in determining that the instant trusts were "paper trusts." In so holding he must be deemed to have ruled as a mat-

ter of property law that the trusts had no existence. When the issue is one of property law, the law of the state, here California, must govern.

Mr. Justice Reed in *Helvering v. Stuart,* 317 U. S. 154, 63 S. Ct. 140 (1942), at pages 161, 162, said:

> "The intention of Congress controls what law, federal or state, is to be applied. * * * Grantees under deeds, wills, and trusts alike, take according to the rule of the state law. The power to transfer or distribute the assets of a trust is essentially a matter of local law. * * * Once rights are obtained by local law, whatever they may be called, these rights are subject to the federal definition of taxability."

(ii) The Trusts Here in Question Are Valid and Existing Under California Law.

The trusts were in writing [Tr. 171, 193]. They governed a specifically identifiable trust *res* [Tr. 194, 195]. They designated an identifiable living beneficiary [Tr. 177, 193]. They provided for lawful purposes, namely, the ultimate delivery of income and principal of property transferred to the children of the trustors respectively or to the lawful issue of such children (Cal. Civ. Code, Secs. 2220, 2221).

The trial court apparently assumed that the trustor in each case was the trustee of his or her own trust. Such, however, was not the case as each appellant trustor was trustee for the other's trust. But even if the trustor had been his own trustee each trust would have been valid.

Restatement—Trusts, Sec. 28;

1 Scott on Trusts, Sec. 17.1;

Noble v. Learned, 153 Cal. 245, 94 Pac. 1047 (1908).

(iii) Neither the Discretions Granted the Trustees nor Any Exculpatory Clauses Contained in the Instruments Impaired the Validity of Said Trusts.

The trust instruments here in question granted certain broad discretions to the trustees with respect to the administration of the trusts and the distribution of income and principal. In addition, the trustees were exempt from liability for losses unless due to the trustees' gross negligence.

None of these provisions, however, would under any circumstances, destroy the trusts. The instruments in question under the law of the State of California conferred basic rights upon the trusts' beneficiaries and similar liabilities upon the trustees.

Loescher v. Whipple, 104 Cal. App. 782, 286 Pac. 741 (1930);

Hornung v. Sedgwick, 164 Cal. 629, 130 Pac. 212 (1913);

I Nossaman, Trust Administration and Taxation, Sec. 12;

Cal. Civ. Code, Secs. 2228, 2229, 2236, 2258.

(iv) Under the Trusts in Question the Rights of the Beneficiaries Were at All Times Enforceable by the Courts of the State of California.

The conduct of the trustees, regardless of the discretions granted, cannot be wholly arbitrary, dispensing with the use of all judgment, still less could it be fraudulent.

Neel v. Barnard, 24 Cal. 2d 406, 150 P. 2d 177 (1944);

Estate of Marré, 18 Cal. 2d 184, 114 P. 2d 586 (1941);

Cal. Civ. Code, Sec. 2269.

(v) The Trust Assets Could Not Have Been Recaptured by Either Appellant.

The trusts by their terms were expressly made irrevocable. Each trustor was specifically excluded as a beneficiary under the trust under any possible contingency [Tr. 181]. It is elementary that any such recapture of the property would have been a fraud upon the trust, subject to condemnation and correction in every court in the land.

> *Carrier v. Carrier,* 226 N. Y. 114, 123 N. E. 135 (1919);
>
> *Colton v. Colton,* 127 U. S. 300, 8 S. Ct. 1164 (1888);
>
> II Scott on Trusts, Secs. 187.4, 222.3;
>
> *Stix v. Com.,* 152 F. 2d 562 (C. C. A. 2d, 1945);
>
> *Warren v. Pazolt,* 203 Mass. 328, 89 N. E. 381 (1909);
>
> *Corbett v. Benioff,* 126 Cal. App. 772, 14 P. 2d 1028 (1932).

In considering the law applicable to these trusts it should be remembered that the Appellants themselves by their conduct recognized their validity. The trial court in its Memorandum Decision [Tr. 19] said:

> "That the parents generously deposited the profits of the partnership to the trust and did not draw from them even legitimate moneys for the education of the children so that, in 1948, the value of each trust was around $115,000.00, is praiseworthy."

In addition, during the trial the court made the following comments [Tr. 144]:

> "So that that is an element which often is not present in other trusts of this kind, because there is

some kind of a siphoning off of the income, whether for the maintenance of the children, or otherwise, you see, and that is not present here."

Again, the Court said [Tr. 150]:

"To that extent the case is a little different from some of the others, because in reality, through the high sense of honor—and I say that sincerely—the high sense of honor that the parents had, they felt, although, as I say, I think they could have squandered the money if they wanted to, but with the high sense of honor they had, they did not take out of the trust funds even the legitimate expenditures for the children's education, which any court would allow them to do."

Finally, we know of no case in which any court has held an *inter vivos* trust as opposed to a court appointed trust or a guardianship invalid *per se* in determining the validity of a family partnership.

On the other hand, in a number of cases such trusts were expressly approved. And this was true even though the parent was the trustee of his own trust and a partner in his individual capacity with said trust.

Greenberger v. Com., 177 F. 2d 990 (7th Cir., 1949);

Miller v. Com., 203 F. 2d 350 (6th Cir., 1953);

Scofield v. Mauritz, 206 F. 2d 135 (5th Cir., 1953).

As a matter of fact the trial judge in the instant case approved children's *inter vivos* trusts as partners where the uncle of the grantor-partner was the trustee. *Osbrink v. United States,* C. C. H., U. S. T. C. 1952-2, Par. 9499 (not officially reported).

It is submitted that under all the circumstances the court's conclusion that the trusts in question were invalid was totally erroneous.

(4) "The lack of any expectation that the children would go into business * * *"

We have heretofore pointed out that so far as the above quotation is a statement of fact it has no foundation in the record. Instead, the contrary is true.

(5) "The large salary voted himself by the father—$25,000 * * *"

In the first place, there is nc justification for the use of the word "large." Although the court does not so find, the implication is plain that the term "large" is intended to mean excessive. We respectfully submit that in view of the contribution of the Appellant to the success of the partnership, and in the light of its earnings, the salary was eminently reasonable. Further, salaries were paid to the Appellant Rose Mae Smith and to the stranger partner, Herman Weishaupt.

As a matter of fact, where, as here, capital was a material income producing factor, the payment of salaries to the partners who devote their time to the affairs of the partnership has always been deemed strong evidence of validity. Failure to pay such salaries has been pointed up as evidencing lack of bona fides.

In 1951 the Internal Revenue Code (Sec. 191) was amended specifically to provide in part as follows:

> "In the case of any partnership interest created by gift, the distributive share of the donee under the

> partnership agreement shall be included in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, * * *"

Further, the Commissioner himself in a Mimeograph commenting upon *Com. v. W. O. Culbertson, Sr., et ux.*, 337 U. S. 733, 69 S. Ct. 1210 (1949), specifically held that the payment of an adequate salary to an active partner was strong evidence of validity. (*Mimeograph 6767, Internal Revenue Cumulative Bulletin 1,* page 111 (1952).)

As a matter of fact, it is respectfully submitted that if the instant case had arisen after 1951 no question would have been raised with respect to the bona fides of this partnership.

Finally, a number of courts have commented on the presence or lack of salary as indicating validity or invalidity. In *Greenberger v. Com.,* 177 F. 2d 990 (7th Cir., 1949), the court said in reversing the Tax Court:

> "While petitioner undoubtedly was the predominating force in the conduct and management of the business, the Commissioner overlooks the fact that the partnership paid him a salary of $45,000 per annum during each of the taxable years for services rendered."

In *Harold Maxwell, Sr.,* 12 T. C. Memo. Op. 63 (1953), affirmed 208 F. 2d 542 (4th Cir., 1953); *cert. den.* 347

U. S. 1013, 74 S. Ct. 866 (1954), the Tax Court, in finding the partnership invalid, said:

> "While capital was a material income producing factor, the original partners, whose knowledge, skill, and personal services largely contributed to the success of the business, continued to exercise the absolute control and management of the business without salaries, notwithstanding their lesser interest in the partnership."

We respectfully submit that the payment of a salary to Appellant Jack Smith and certain of the other partners demonstrated validity rather than invalidity.

(6) "The unlimited control of both the trusts and partnership."

The basic error in the above statement, both as a matter of fact and law, has already been amply demonstrated and need not be further argued here.

It is respectfully submitted that none of the conclusions of law upon which the trial court based its judgment for Appellees as applied to this particular proceeding are legally defensible.

C. It Is Respectfully Submitted That the Trial Court Should Have Found the Partnerships in Question Valid for Tax Purposes Because the Parties to the Partnerships Really and Truly Intended to Join Together for the Purpose of Carrying on a Business as a Partnership and Sharing in the Profits and Losses of Said Enterprises.

It is unnecessary here to refer in detail to the authorities governing the determination of this troublesome question. This Court has been required on many occasions to review this problem and is fully familiar with the law applicable thereto.

Nor, we believe, is it necessary to restate the facts upon which the claim of validity just stated is predicated. Appellants' statement of "Facts Involved," which is amply supported by reference to the record, brings this proceeding, we submit, squarely within those authorities holding particular partnerships to be valid for income tax purposes.

We have examined all the family partnership cases decided by this Court since the decision of the Supreme Court in *Com. v. W. O. Culbertson, Sr., et ux., supra.* We believe that the decisions in *Com. v. Sultan,* 210 F. 2d 652 (9th Cir., 1954); *Com. v. Brodhead,* 210 F. 2d 652 (9th Cir.); *Com. v. Eaton,* 210 F. 2d 653 (9th Cir., 1954), and *Snyder v. Westover,* 217 F. 2d 928 (9th Cir., 1954), are applicable here and require a finding in the instant case that valid partnerships existed.

In the cases just cited, of course, the partnership was sustained. On the other hand we find nothing at variance with what has been here suggested in those cases in which this Court has refused to recognize the family partnership for tax purposes. Each of said *contra* cases has been carefully examined and it is believed that the facts in each are basically different from those here involved.

D. Even if It Should Be Held That, Because of Certain Elements of Control, the First Partnership Which Existed From October 1, 1943 to December 31, 1944 Was Invalid, It Still Follows That the Second Partnership Was a Valid Business Enterprise.

It has heretofore been repeatedly pointed out that the trial court failed completely to distinguish between the two partnerships with which we are here concerned. In the first partnership only the Appellants and the two trusts were involved. In the second partnership a new partner, not related to Appellants, entered the business, contributing both capital and services.

At the same time certain rights granted Appellant Jack Smith under the first partnership agreement were completely eliminated.

Under no theory that we know of could the second partnership be ignored for income tax purposes.

E. Regardless of All Other Considerations the Judgment of the Trial Court Must Be Reversed Because Said Court Made No Finding of Fact as to Lack of Good Faith in the Formation of the Partnership.

The findings of fact are completely silent as to possible lack of good faith with respect to the formation of the partnerships. While the conclusions of law contain the following statement [Tr. 29]: "Neither children nor trusts for children either intended to or did enter into a bona fide partnership with the parents for a business purpose," said statement is a conclusion of law and not a finding of fact.

This Court said in *Snyder v. Westover, supra,* in reversing the trial court:

> "The trial court did not make any finding as to lack of good faith on the part of the parties in the formation of their apparently valid partnership. The recent case of *Dyer v. Commissioner,* 1954 2 Cir. 211 Fed. (2d) 500, states at page 506: 'Finally and above all, the Supreme Court had not yet required, as it later did in *Culbertson,* that there be an explicit finding, *as a fact,* of lack of good faith intention before an apparently valid joint venture agreement could be ignored. The judge here made no such finding. Had he done so, basing it on all the elements of the situation (including among other things, the fact that the women had not read the contracts they signed) and resting his finding in part on a testimonial inference resulting from his observation of the demeanor of the witnesses who testified orally, we would have affirmed.' For this and other foregoing reasons, the court erred in his conclusions and in his judgment." (Emphasis supplied.)

In calling to this Court's attention the failure of the trial court to make the finding of fact just referred to, we are not suggesting that this proceeding be remanded to the trial court. We respectfully submit that no such remand is here necessary. We are merely calling this situation to this Court's attention as a further indication of the trial court's failure to correctly find the facts involved and apply the law applicable.

Conclusion.

It is respectfully submitted that the judgment of the trial court in favor of Appellees should be reversed and that judgment should be entered for Appellants.

Respectfully submitted,

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Dated: March 7, 1955.